IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

JOHN E. TOBIN
ROGER W. KAPP
RICHARD H. SAYLER
BRENT L. BRANDENBURG
Attorneys for Investors Diversified Services, Inc.
30 Rockefeller Plaza
New York, New York 10020

DONOVAN LEISURE
NEWTON & IRVINE
JOSEPH F. GRINNELL
Senior Vice President—Law
Investors Diversified Services, Inc.
Of Counsel

June 9, 1978

TABLE OF CONTENTS

TABLE OF AUTHORITIES

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

Investors Diversified Services, Inc. ("IDS"), files this brief as *amicus curiae* with the consent of all parties, urging that the Petition for a Writ of Certiorari be granted. The decision of the Court of Appeals for the Second Circuit below is of substantial concern to IDS, the investment adviser to the nation's largest mutual fund complex.[1] The decision held as a matter of law that a quorum of investment company (mutual fund) independent directors may not terminate shareholder derivative litigation, allegedly brought for the corporation's benefit, despite such quorum's unanimous determination

---

[1] IDS is the investment adviser to ten open-end mutual funds. IDS-associated mutual funds have assets exceeding $5 billion, held on behalf of over one million shareholder accounts.

that prosecuting the action would not be in the best interests of the fund. At the very least, this decision places mutual funds in a uniquely disadvantageous position when their independent directors attempt to decide such questions in the best interests of all of their shareholders.

The issues discussed in Parts I and II herein did not receive extended consideration by the Court of Appeals. The District Court upheld the powers of independent mutual fund directors to dispose of shareholder derivative claims, but the Court of Appeals elected to reverse on grounds which were, at least in part, significantly different from those urged by the shareholder-plaintiffs (respondents herein). Thus, the impact of the reasoning employed by the court below was largely unanticipated.

In this brief, IDS seeks to bring to the Court's attention the pervasive ramifications of the decision below to the mutual fund industry and to the federal court system, and to emphasize that a resolution of now-conflicting applications of rules for corporate governance is of critical importance to the functioning of the entire mutual fund industry, and indeed to corporations generally.

Opinions Below

The opinion of the Court of Appeals, *Lasker* v. *Burks*, is reported at 567 F.2d 1208 (2nd Cir. 1978). The opinion appears at page 24a, *et seq.*, of the Appendix to Petition for a Writ of Certiorari ("Petitioners' Appendix") filed by Harry G. Burks, Jr., *et al.* ("Petitioners"). Also set forth in the Petitioners' Appendix, at pages 1a and 14a, respectively, are the opinions of the United States District Court for the Southern District of New York dated

October 17, 1975 (as amended), reported at 404 F.Supp. 1172, and January 7, 1977, reported at 426 F.Supp. 844.

Questions Presented

1. Whether the federal policy respecting mutual funds as expressed in the Investment Company Act preempts long-established state corporation law authorizing independent directors to determine whether the maintenance of a shareholder derivative action is in the best interests of the corporation.

2. Whether the policies embodied in Rule 23.1 of the Federal Rules of Civil Procedure requiring a shareholder who seeks to sue derivatively to exhaust his intra-corporate remedies should be abrogated by a judicially-created irrebutable presumption, which cannot logically be confined to the mutual fund context, that the independent members of a mutual fund board of directors can never fairly evaluate a possible claim against the other directors.

3. Whether the independent members of the board of directors of a mutual fund, whose presence on such board is specifically mandated by the Investment Company Act so that they may serve as "watchdogs" for the interests of the fund and its shareholders, should be under any special disability in deciding whether or not the fund's best interests are served by pursuing derivative claims brought by a shareholder allegedly for the fund's benefit.

Rules and Statutes Involved

The statutes and rules involved in this case are the Delaware General Corporation Law, 8 Del. Code §§ 141(a) and (b) (1974), sections 36(a) and (b) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-

35(a) and (b) (1970), and Rule 23.1 of the Federal Rules of Civil Procedure. These statutes and rules are set forth in full in Appendix A hereto.

Statement of the Case

Fundamental Investors, Inc. ("Fundamental"), was chartered as a corporation by the State of Delaware on October 17, 1932 for the purpose of engaging in the mutual fund business. By 1969, Fundamental had over 90,000 shareholders and a portfolio of approximately $1 billion. On November 26, 1969 it purchased, as a short-term investment, $20 million of 270-day notes issued by the Penn Central Transportation Company. Because of Penn Central's bankruptcy in June, 1970, the notes were not paid at their maturity.

The notes had been sold to Fundamental by Goldman, Sachs & Co. ("Goldman, Sachs"), a leading commercial paper dealer. On November 4, 1970 Fundamental brought suit against Goldman, Sachs, claiming that it had violated various anti-fraud provisions of the federal securities laws, and seeking rescission of the Penn Central note transaction.

In early 1973, more than three years after Fundamental had purchased the Penn Central notes, two of Fundamental's more than 90,000 shareholders (hereinafter "respondents") commenced the instant derivative action, allegedly on behalf of and for the benefit of Fundamental, without making a demand upon the directors. Named as defendants were Fundamental, its investment adviser, and all of Fundamental's ten directors serving in 1969 when the notes were purchased.

The complaint sought damages for the defendants' alleged violation of §§ 13(a)(3) and 36 of the Investment Company Act of 1940 (15 U.S.C. §§ 80a-13(a)(3) and 80a-35), and § 206 of the Investment Advisers Act (15 U.S.C. § 80b-6). It also alleged that certain defendants breached common law fiduciary duties and the investment advisory contract. The principal thrust of the factual allegations was that the investment adviser made an insufficient examination of Penn Central's financial condition prior to purchase of the notes. Further proceedings in the action were stayed by the District Court pending resolution of Fundamental's lawsuit against Goldman, Sachs.

On July 9, 1974, after completion of discovery and one day before the scheduled commencement of trial, Fundamental settled its claims against Goldman, Sachs. Goldman, Sachs took back the Penn Central notes, paid Fundamental $5.25 million in cash, and assigned to Fundamental a 73.75% interest in the proceeds of the notes in the Penn Central reorganization proceedings.[2]

At its next regular meeting after settlement with Goldman, Sachs, Fundamental's board reviewed the status of respondents' suit. The board decided that the five directors who were not named as defendants[3] would act as a quorum of the board, pursuant to Section 141 of the

---

[2] On March 9, 1978, the United States District Court for the Eastern District of Pennsylvania preliminarily approved a Penn Central plan of reorganization, *see*, The Wall Street Journal, March 10, 1978, at 37 col. 1.

[3] Five of Fundamental's directors assumed office after the purchase of the Penn Central notes, and were thus not named as defendants. Louis F. Laun was elected in 1971, Mary S. O'Connor in 1972, Dr. Beryl Robichaud and William J. Stephens in 1973, and Leon T. Kendall in 1974. *See*, Petition for a Writ of Certiorari, at 5,n.*.

Delaware General Corporation Law and Fundamental's Bylaws, to determine what position Fundamental should take regarding this action. These five directors (hereinafter the "independent directors") were all statutorily disinterested persons under the Investment Company Act (15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a)), were not directors at the time of the events complained of, and were not affiliated in any way with Fundamental's investment adviser. The remaining directors agreed to take no part whatsoever in the independent directors' determination.

On July 24, 1974, the independent directors retained special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to advise them concerning Fundamental's possible claims against its investment adviser and the other defendants. Special counsel had no previous connection with any of the parties. Special counsel studied respondents' complaint, the proceedings in the action against Goldman, Sachs, and the files of Fundamental and its investment adviser relating to the Penn Central note transaction; he interviewed officers and employees of Fundamental and the adviser; and he analyzed the facts and the law. On December 5, 1974, special counsel reported to the independent directors in a comprehensive 40-page legal and factual memorandum, concluding that there was no violation by the defendants herein of any statutory, common law or contractual duty to Fundamental.

The independent directors met, reviewed the subjects raised by special counsel's memorandum, discussed the various alternatives open to Fundamental, and posed additional questions to special counsel. He then sent a supplemental memorandum to the independent directors on December 18, 1974, pointing out that whether or not the claims were to be enforced in the courts was, like other matters concerning the corporation's best interests, properly committed to the discretionary business judgment of the independent directors.

The independent directors then held a series of discussions and special meetings to consider special counsel's memoranda. On January 6, 1975, they unanimously determined that prosecution of respondents' suit was contrary to the best interests of Fundamental and its shareholders (other than the two respondents). The factors relied upon by the independent directors included the dim prospects of recovering from any defendant amounts beyond those already paid by Goldman, Sachs; special counsel's opinion that there was no merit to the claims and little likelihood of success; the substantial litigation expense to Fundamental; and the major disruption of Fundamental's affairs which would accompany litigation, including the probability that Fundamental would have to replace its investment adviser. See, 404 F.Supp., at 1176-77 (S.D.N.Y. 1975; Werker, J.).

On instructions from the independent directors, litigation counsel for Fundamental thereafter moved to dismiss respondents' action as not being in the best interests of the corporation. The District Court held that Fundamental's board had complete power under the business judgment rule to bar prosecution of this action if the directors who made the decision were truly disinterested and independent. *Id.*, at 1180.

Because respondents made a factual issue of whether the quorum of five directors was disinterested and independent, the District Court directed further proceedings related solely to that issue. After exhaustive discovery on this question, on January 7, 1977 the court granted Fundamental's motion to dismiss. The court found that the respondents "have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently." 426 F.Supp. 844, 849 (S.D.N.Y. 1977).

Respondents appealed to the Court of Appeals for the Second Circuit. On January 11, 1978, that court reversed, holding that the independent directors were not entitled to terminate respondents' derivative action. A petition for rehearing in banc was denied on March 9, 1978.

Summary of Argument

The decision of the Court of Appeals for the Second Circuit in the case at bar incorrectly disregarded controlling principles of state corporate governance law. The court below held, *as a matter of law,* that a quorum of mutual fund directors found by the District Court to be "truly independent" was disqualified from deciding to terminate a shareholder derivative suit, allegedly brought for the corporation's benefit, which it had determined was not in the best interests of the corporation, despite the fact that the independent directors who comprised the quorum made such determination in "good faith" after extensive consultation with independent special counsel.

There is a well-settled principle of state law, generally referred to as the business judgment rule, which places the responsibility for the management of a corporation—including decisions as to whether or not to pursue a possible corporate claim through litigation—in the hands of independent directors duly elected by the corporation's shareholders. The District Court honored this principle, but the Court of Appeals regarded it as irrelevant. The result reached below, if applied generally, threatens the basic structure of intra-corporate governance by permitting two recalcitrant shareholders among 90,000 to impose their will upon the corporation by continuing to maintain this litigation, ostensibly on behalf of the corporation, in spite of the informed opposition of the independent directors who assessed the proposed claims.

Although the Court of Appeals purported to find support for this extraordinary result in the fact that respondents were presenting claims involving federal policies, such a basis for ignoring state corporate governance law is clearly inconsistent with a long line of decisions of this Court. The most recent such decision, *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 479 (1977), holds that such state law will be displaced only when federal law "expressly" requires it—a test not satisfied here.

The Court of Appeals also buttressed its decision to ignore settled state law by creating an irrebuttable presumption of law that the independent members of a board of directors are incapable of passing fairly upon proposed corporate claims directed in part at their fellow directors, 567 F. 2d, at 1212, and by referring to "the unique nature

of the investment company and its symbiotic relationship with its investment adviser." *Id.*, at 1212, n.14. Neither of these rationales withstands analysis.

The presumption employed by the Court of Appeals to ignore the independent directors' decision cannot logically be confined to corporations which happen to be mutual funds. Thus, unless reversed, it has the potential to greatly expand shareholder derivative litigation (involving both mutual funds and other public corporations) in the federal courts by rewriting Rule 23.1 of the Federal Rules of Civil Procedure so as to eliminate, for all practical purposes, the requirement of a demand on directors prior to the commencement of derivative litigation. Since shareholder derivative plaintiffs will, on this analysis, now be able to maintain suits in spite of the opposition of an independent quorum of the board, the decision below reverses the traditional preference for corporate rather than judicial determination of whether or not to sue on proposed corporate claims.

Finally, to the extent that the Court of Appeals sought support for its decision in the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, it drew from the legislative materials precisely the opposite conclusion from that intended by Congress, which has attempted to enhance and strengthen the role of mutual fund independent directors as "watchdogs" for the interests of all shareholders. The decision below conflicts not only with Congressional intent, but also with a leading decision of the Court of Appeals for the First Circuit and previous decisions in the Second Circuit which have consistently interpreted the Investment Company Act to uphold the right and duty of mutual fund independent directors to determine whether the pursuit of shareholder derivative

claims is in the best interests of the fund. If allowed to stand, the decision below significantly limits the opportunity of such directors to exercise their responsibility in an important area of mutual fund management.

REASONS FOR GRANTING THE WRIT

I. The Decision of the Court of Appeals Preempts State Law Corporate Governance Principles in Violation of Numerous Decisions of this Court

It has long been a settled tenet of corporate law that the board of directors has the responsibility and duty, imposed by the chartering state, to run the corporation. This principle is fundamentally democratic: since directors are elected by vote of all of the shareholders for the very purpose of deciding where the best interests of the corporation lie, their business judgment may not ordinarily be questioned in the courts at the behest of a single shareholder. *Hawes* v. *Oakland*, 104 U.S. 450 (1881); 2 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 505, 528 and 535 (1969 ed.).

The business judgment rule is particularly important in the area of directors' control over corporate assets, including the disposition of possible corporate claims. This Court emphasized in *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903), that:

> "[A] court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an

act which their judgment does not approve, or to substitute his judgment for theirs."

This organizational structure in which directors rather than shareholders are charged with running the affairs of a corporation is a creation of state, not federal, law. Corporations in fact owe their very existence to state law.[4] Fundamental—the corporation whose interests are the only ones in issue in this case—is a Delaware corporation, deriving such powers as it possesses under its Certificate of Incorporation and Bylaws directly from the Delaware General Corporation Law.

Under Delaware law, independent directors (such as the five who acted here), rather than one or more of the corporation's shareholders, are charged with the responsibility for, and have complete powers of disposition over, claims by and against the corporation.[5] The Delaware courts have repeatedly held that a good faith exercise of business judgment by a corporation's board of directors—including decisions whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit.[6]

---

[4] Recent proposals for the federal chartering of corporations, see *e.g.*, Nader, et. al., *Constitutionalizing the Corporation: The Case for the Federal Chartering of Giant Corporations* (1976), have not resulted in new federal statutes.

[5] Delaware Code, Title 8, § 141 (1975); *see also, Cohen* v. *Beneficial Loan Corp.*, 337 U.S. 541, 549 (1948); *Davis* v. *Louisville Gas & Electric Co.*, 16 Del. Ch. 157, 142 A. 654 (1928).

[6] *See e.g., McKee* v. *Rogers*, 18 Del. Ch. 81, 156 A. 191 (1931); *Ella M. Kelly & Wyndham, Inc.* v. *Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz* v. *Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (1963); *Beard* v. *Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 738-9 (1960); *Puma* v. *Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971). This rule is one of general application under the corporation laws of most if not all jurisdictions. *See, Swanson* v. *Traer*, 249 F.2d 854 (7th Cir. 1957).

Only in limited circumstances may shareholders bring suit derivatively to redress harm done the corporation. Because such suits may not be consistent with the best interests of all shareholders and may be abused,[7] several significant limitations have been imposed on derivative litigation. One of the most important is the requirement that a dissident shareholder exhaust intra-corporate remedies. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168 (1976). The exhaustion requirement is implemented by imposing a duty on the shareholder to make a demand on the directors to sue on his proposed claim, or to demonstrate why such a demand would be futile.[8] If the directors conclude not to sue, their decision will be tested under the business judgment rule and will be final unless the shareholder can demonstrate that the board has wrongfully refused to pursue a proposed cause of action on behalf of the corporation.[9]

This established state-law framework has been rejected, at least insofar as corporations which are mutual funds are concerned, by the decision of the court below, which permits two shareholders to substitute their judgment for that of a quorum of its directors determined by the District Court to be "truly disinterested and independent." 426 F.Supp., at 847. The Court of Appeals' decision

---

[7] *See, Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-41 (1975).

[8] *See, e.g.*, Rule 23.1 of the Federal Rules of Civil Procedure; Delaware Chancery Court Rule, Rule 23.1. The historical background of Rule 23.1 is summarized in *Heit* v. *Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977).

[9] Comment, *supra*, 44 U.Chi.L.Rev., at 193-98; *City of Detroit* v. *Dean*, 106 U.S. 537, 541-42 (1882); *McKee* v. *Rogers*, *supra*.

requires a trial herein, notwithstanding the independent directors' informed judgment that the case is not in the corporation's best interests.[10]

The Court of Appeals erroneously believed that it was empowered to disregard state corporate governance law because the shareholders' claims were, at least in part, based on alleged violations of federal policies as set forth in the Investment Company Act. This holding disregards a long and remarkably uniform series of decisions by this Court that shareholders cannot wrest from the directors control of the prosecution of claims brought on the corporation's behalf in the federal courts.[11]

In *Price* v. *Gurney*, 324 U.S. 100 (1945), corporate security holders filed a derivative petition alleging, as do the respondents here, that the pervasive policy embodied in a federal statute (the Bankruptcy Act) permitted them to override the business judgment of the board of directors and maintain an action for the corporation's benefit without directorial consent. This argument was quickly rejected:

> "[N]owhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation. Respondents may have a meritorious case for relief. On that we intimate no opinion. But if they are to be allowed to put their corporation into bankruptcy, they must present credentials to the bankruptcy court showing their authority." 324 U.S., at 107.

[10] The reasons why the directors determined not to pursue the claims proposed by respondents are summarized *supra* at p.7.

[11] The Court of Appeals' decision acknowledged the primacy of Delaware law as determinative of most questions regarding the independent directors' actions herein, but ignored this controlling body of law in passing upon the business judgment issue which was presented, *see* 567 F.2d, at 1210, n.5. *Cf.*, *Untermeyer* v. *Fidelity Daily Income Trust*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,419 at 93,513, n.17 (D. Mass., May 4, 1978).

There are, of course, certain areas of substantive law where under the Supremacy Clause federal law preempts state law. The court below evidently presumed that it was empowered to ignore state corporate law because a federal policy in favor of protecting mutual fund investors permitted it. However, until the decision below there has never been the slightest suggestion that state law control of intra-corporate decision-making is susceptible to federal preemption, no matter how "strong" a federal policy is involved.

The federal policy underlying the antitrust laws is so strong that the Sherman Act has been characterized as "the Magna Carta of free enterprise." *U.S.* v. *Topco Associates, Inc.*, 405 U.S. 596, 610 (1972). Yet even this fundamental federal policy does not displace the business judgment rule when a shareholder seeks to assert derivatively a corporate antitrust claim over directorial opposition. In *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917), this Court flatly rejected a shareholder attempt to bring a treble-damage action on behalf of a corporation after its directors had declined to institute suit. In response to the same argument advanced by respondents below—that federal policy would be

thwarted unless the corporation's business judgment was overridden—Justice Brandeis held that:

> "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation." 244 U.S., at 264.

The principle set forth in *Price* and *United Copper* has been unwaveringly followed by this Court. *See, Cort* v. *Ash,* 422 U.S. 66 (1975).[12] Indeed, even in the area of federal regulation of transactions in securities this Court has refused to allow interference with state laws of corporate governance. In *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977), this Court refused to allow a shareholder to maintain a derivative action raising federal securities antifraud claims (analogous to those raised by respondents here) on behalf of a corporation involved in a Delaware statutory short-form merger. Reiterating its earlier holding in *Cort v. Ash, supra,* the Court stated in *Santa Fe* that:

> "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." 430 U.S., at 479.

This Court has thus consistently refused to disturb the state law axiom of corporate governance that independent and disinterested corporate directors have the final responsibility and obligation to determine the course of action which is in the corporation's best interests. The business judgment rule defeats attempts by shareholders to sue over the directors' objection, and fully applies whether the claim sought to be asserted relates to some federal policy or not.

The court below was cognizant of the foregoing authority, but nevertheless concluded that "the plethora of cases . . . dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite." 567 F.2d, at 1212, n. 14. It offered two reasons for its decision to disregard these principles. The first was an irrebuttable legal presumption (based largely upon subjective psychological factors) that the independent directors were here disqualified from exercising their business judgment because they could not pass fairly on a claim directed in part at some of their fellow directors. Since the independent directors "must constantly deal with majority directors in a spirit of accommodation,"

---

[12] In *Cort* v. *Ash,* this Court was faced with a shareholder derivative claim bottomed upon as intrinsic a federal concern as the integrity of federal elections under the Federal Election Campaign Act. There, as here, the shareholder, complaining of supposed federal statutory violations, asserted the right to maintain his damage action for the corporation's benefit. Justice Brennan, writing for a unanimous court, stated that:

> "[A private cause of action by a stockholder to secure derivative damage relief] is available, if at all, under Delaware law governing corporations.
>
> * * *
>
> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation. . . . We are necessarily reluctant to imply a federal right to recover funds used in violation of a federal statute where the laws governing the corporation may put a shareholder on notice that there may be no such recovery." 422 U.S., at 77-78, 84-85 (footnote omitted).

since they must "rely on the information and expert advice provided by the adviser and the majority directors," and since their continued service and receipt of directors' fees "depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection," the court below stated that:

> "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." *Id.,* at 1212.

The second reason offered was "the unique nature of the investment company and its symbiotic relationship with its investment adviser," *id.,* at 1212, n.14, which the Court of Appeals discerned from a selection of previous mutual fund decisions and the federal statutory framework regulating certain mutual fund activities.

We submit that neither reason provides sufficient basis for a decision which is incompatible with this Court's prior decisions in *Price, United Copper, Cort,* and *Santa Fe.* Those decisions require compliance with state law concerning corporate governance. In Parts II and III, below, we examine both of these reasons in greater detail and demonstrate that they are themselves unsound as a matter of law, policy, and logic.

II. The Decision of the Court of Appeals Threatens to Expand Greatly Shareholder Derivative Litigation in the Federal Courts.

We have described above the legal rules governing the relationship between a corporation's board of directors and shareholders who wish to sue derivatively on behalf of the corporation. We have also outlined the irrebuttable legal presumption which the court below created to sweep aside that body of law as irrelevant to its decision. That presumption, which cannot logically be confined to mutual funds, has the potential to greatly increase the burden of shareholder derivative suits in the federal courts, since it conflicts with well established doctrines specifically embodied in Rule 23.1 of the Federal Rules of Civil Procedure, and cases construing that Rule, designed to insure that shareholders exhaust their intra-corporate remedies before commencing suit in the federal courts. Rule 23.1 requires that a shareholder wishing to sue derivatively must allege with "particularity" the effort made to obtain the desired action from the board of directors or the reasons for not making such an effort.[13]

In the present case, respondents sought to satisfy Rule 23.1 by alleging in their complaint that no demand on Fundamental's directors was made:

> ". . . because the Fund's Board of Directors is dominated and controlled by the Adviser and the

[13] Rule 23.1, Fed. R. Civ. P., entitled "Derivative Actions by Shareholders," provides in pertinent part:

> "In a derivative action brought by one or more shareholders . . . to enforce a right of a corporation . . ., the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and, if necessary, from the shareholders . . . , and the reasons for his failure to obtain the action or for not making the effort. . . ."

individual defendants continue to be a majority of the Fund's Board of Directors and they have participated, cooperated and aided and abetted in the wrongful acts, transactions and delinquencies complained of. No action could or would be permitted to be instituted by the Fund without the consent of the Fund directors. The Fund's Board of Directors for a considerable time has been fully aware of the wrongful acts herein alleged and has nevertheless failed to take action. Consequently, any demand upon the Fund's Board of Directors would be futile and useless and any such action that would be instituted by the Board of Directors on behalf of the Fund would be friendly to the defendants, would not be diligently prosecuted and would be hostile to the interests of the Fund and its stockholders." Complaint, ¶7(a).

Faced with such a complaint, Fundamental's board had two options that would allow it to fulfull its obligations to all of the shareholders: (1) to attack the sufficiency of these allegations by means of a motion to dismiss for failure to satisfy Rule 23.1; or (2) to proceed, through the quorum of independent directors, to assess the wisdom of the proposed claims as though a demand had been made. Either option, if successful, would provide the independent directors an opportunity to review the proposed suit in light of Fundamental's best interests. The board chose the second option.

A motion to dismiss attacking the sufficiency of respondents' Rule 23.1 allegations would have presented several distinct problems, not the least of which is the

widely varying judicial attitude concerning the Rule itself.[14] Indeed, some courts have acknowledged that there is a conflict in the circuits concerning the standards applied to such motions. As the Court of Appeals for the First Circuit recently stated in *Heit* v. *Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977):

> "Courts have tended to vary in the rigor with which they enforce Rule 23.1, *see*, Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv.L.Rev. 746, 747 (1960); in this circuit, the rule has been vigorously enforced. We said in [*In re*] *Kauffman* [*Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973),] that this requirement both continues a long tradition in the federal courts previously codified as Equity Rules 93 and, later 27, and represents a deliberate departure from the relaxed policy of 'notice' pleading promoted elsewhere in the Federal Rules. The requirement places an initial burden on the stockholder 'to demonstrate why the directors are incapable of doing their duty,' *id.* at 263, and failure to meet this burden requires dismissal of the suit."[15]

---

[14] Professor Moore has observed that "[t]here is no unanimity of opinion amongst the courts, and probably the most straight-forward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand." 3B Moore's Federal Practice, ¶ 23.1.19, at p. 23.1-83 (2d ed. 1975).

[15] *Compare*, *Kauffman* and *Heit with*, *deHaas* v. *Empire Petroleum Co.* 286 F. Supp. 809 (D. Col. 1968), *aff'd*, 435 F.2d 1223, 1228 (10th Cir. 1970) ("[c]ourts have generally been lenient in excusing demand"). *See also*, *Untermeyer*, n.11, *supra*.

Despite this and other problems,[16] dismissal motions grounded upon Rule 23.1 have been successful in instances where: (1) a majority of the board of a corporation was not shown to be disabled from passing on the question presented;[17] or (2) the composition of the board had changed significantly between the time either when the cause of action arose, when a previous demand was rejected, or when a complaint was filed, and the time of moving for dismissal.[18] Such a motion should also be

[16] There is also a split of authority concerning whether it is proper to consider affidavits in deciding such a motion. *See*, cases cited in Comment, *supra*, 44 U.Chi.L.Rev., at 181, n. 90. Affidavits setting forth uncontested facts concerning the membership of the board over time and directors' backgrounds may be critical for an accurate response to broad, conclusory allegations—such as respondents used here—designed to show that the board is disabled from fairly considering whether to pursue a proposed claim. *See, e.g. Baffino* v. *Bradford*, 57 F.R.D. 79 (D.Minn. 1972), where Chief Judge Devitt considered affidavits concerning the independence of directors prior to dismissing the complaint for failure to make a demand.

[17] *Kauffman, supra*, 479 F.2d at 264; *Heit, supra*, 567 F.2d, at 1161; *Abrams* v. *Mayflower Investors, Inc.*, 62 F.R.D. 361, 368-70 (N.D. Ill. 1974); *Lerman* v. *ITB Management Corporation*, 58 F.R.D. 153, 156-59 (D.Mass. 1972). *See also, Untermeyer, supra*, at 93,512-13 (board evenly divided between interested and independent directors).

[18] *Brody* v. *Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973), *on remand*, 66 F.R.D. 87, 89 (S.D.N.Y. 1974), *aff'd* 517 F.2d 932, 934 (2d Cir. 1975); *Independent Investor Protective League* v. *Saunders*, 64 F.R.D. 564, 570-71 (E.D.Pa. 1974); *see also, Corey* v. *Independent Ice Co.*, 207 F. 459, 464 (D.Mass. 1913) (complaint alleging demand on directors nineteen months before filing suit should also allege that the same directors were presently in office to comply with the demand requirement); 7A C. Wright and A. Miller, Federal Practice and Procedure: Civil § 1831, at 377-78 (1972 ed.) ("if a substantial period has transpired between the demand and the institution of the action, the court may insist on a second demand or proof that the directors or the nature of the claim have not changed"); 3B Moore's Federal Practice, ¶23.1.19, at 23.1-81-82 (1976 ed.) ("From the particular facts alleged, it must appear that a new board of directors has not been installed. . . . [A] shareholder's suit is to be resorted to as a last alternative, and . . . the corporation is given every possibility to sue in its own name").

available whenever, under the applicable state law, a quorum of independent directors exists to pass upon the shareholder's demand.[19] Analytically there is no distinction between such a case—presented here—and the situation presented in *Heit, supra*, where a derivative complaint was dismissed for failure to show that a majority of the board was disqualified from passing fairly upon plaintiff's proposed claim. Moreover, the current trend in corporate governance away from having a corporate board consisting solely of present officers or employees of that corporation supplies a major impetus for sustaining the practice of allowing an independent quorum of directors to pass upon a demand.[20]

[19] *See, e.g., Gall* v. *Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976); *Auerbach* v. *Bennett*, N.Y. Law Journal, May 10, 1977, p.14 col. 6 (Sup. Ct., West. Co.). Had respondents thereafter sought to dispute the independence of the deciding directors, the most expeditious means of proceeding would have been to grant limited discovery and a separate trial under Rule 42(b) of the Federal Rules of Civil Procedure on the *bona fides* (*i.e.*, the independence) of the quorum of directors who decided the issue. Comment, *supra*, 44 U.Chi.L.Rev., at 198-200; *cf., Wallenstein* v. *Warner*, N.Y. Law Journal, May 9, 1978, p. 11 col. 3 (Sup. Ct., N.Y. Co.). Such a result, of course, would not differ in substance from the procedure District Judge Werker employed in this case.

[20] This trend has been summarized as follows:

> "The Conference Board's Jeremy Bacon confirms that his research over the years has shown a steady increase in the number of manufacturing companies having a majority of outside directors [—those who are not salaried employees of the corporation and who are not involved in day-to-day staff or operating decisions—] on their boards. In 1967 this figure was 63% of the companies studied; in 1973, 71%. The 1976 figure reflects that 83% of the nearly 300 companies studied had such an outside majority.
>
> "A separate analysis of 175 leading corporations (made by my own office) showed 86% with a majority of outsiders, 10% with a minority, and the 4% balance having equal representation of outsiders and insiders. Both my study and that of the

Fundamental's selection of the second available option seems clearly preferable. First, this approach subjects the proposed cause of action to non-judicial but nevertheless independent review on the merits sooner than would be the case if trial were the only alternative.[21] Prompt review of the facts by independent counsel, before memories fade, witnesses die, or evidence is lost, is always useful, particularly where, as here, respondents' complaint was not filed until more than three years after the challenged transactions took place. Second, it permits an evaluation by the independent directors—again at a relatively early stage—of the full range of factors which the courts have repeatedly held are relevant in applying the business judgment rule. Finally, this approach saves the judicial and corporate time and expense attending a dismissal motion based on Rule 23.1 which, even if successful, might still have been followed by proceedings directed at the *bona fides* of the independent directors who passed upon the subsequent demand.

The thrust of respondents' argument below was that many of the business judgment cases discussed herein were inapplicable because they were cases in which a board of directors, after receiving a demand, chose not to

Conference Board confirm that the number of outside directors tends to rise with the size of the company, its complexity, and the extent of its international involvements."

Estes, *The Emerging Solution to Corporate Governance*, 55 Harvard Bus. Rev. 20, 21-22 (Nov.-Dec. 1977).

[21] The case law is clear that the other members of the board, and corporate management, are under a duty to provide the independent directors and their counsel with complete and accurate information upon which to base their decision. *See, e.g., Moses* v. *Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); *Tannenbaum* v. *Zeller*, 552 F.2d 402, 417 (2d Cir.), *cert. denied*, 98 S. Ct. 421 (1977); *Fogel* v. *Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976).

pursue a cause of action proposed by a shareholder, or the shareholder-plaintiff contended that Rule 23.1 demand was excused. Since Fundamental did not attack the complaint on Rule 23.1 grounds, respondents characterized this case as one which was "validly commenced." Respondent's Br., at pp. 27-33, and Reply Br., p. 1, 2d Cir. But that argument, we submit, begs the question.

If the argument is correct, it follows that the *only* opportunity that the independent members of a corporate board will have to pass on whether a proposed cause of action is in the corporation's best interests is if the putative plaintiffs and their counsel are so careless as to make a demand of the board before filing suit. Such a result is inconsistent with the cases discussed above, and with the spirit of Rule 23.1.[22]

Since the demand requirement and the business judgment rule are closely intertwined,[23] the procedural course of action followed by Fundamental should not materially affect whether directorial control of litigation is to be upheld when the deciding directors are truly independent. The court below could have helped to assure such a result by approving the careful course of action followed by the District Court. The central benefit that follows should be fair resolution of more of these disputes within the structure of the corporation itself. The courts would remain available—as they should be—for the

[22] See the discussion at *supra*, pp. 22-23, and accompanying footnotes.

[23] 7A C. Wright & A. Miller, *Federal Practice and Procedure: Civil* § 1832 (1972 ed.); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv.L.Rev. 746, 759 (1960).

limited purpose of testing the independence of the deciding directors.

However, the court below substituted an irrebuttable legal presumption that independent directors of a mutual fund board cannot function independently when considering proposed claims against some of their colleagues on the board, in place of a factual examination of that limited issue where necessary in particular cases. Although it set out several bases for its presumption as to "human nature", the court clearly did not believe that an independent minority of board members—even one constituting over 40% of the board—could ever pass fairly upon proposed corporate claims directed in part at fellow directors.[24] The Court of Appeals expressly stated that it was "unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent," and that it had no doubt that "the five minority directors acted in good faith." 567 F.2d, at 1212.

There is nothing in the court's presumption, or in the assumptions as to "human nature" upon which it is based, that confines its application to corporations which happen to be mutual funds. Thus, the presumption—if applied in future cases to publicly-held corporations generally—would make pointless asking *any* independent director to decide whether to pursue a proposed corporate claim against another director.[25] Moreover, given the presump-

[24] *See*, the discussion, *supra*, at pp. 13-14.

[25] Indeed, one attorney who frequently represents derivative plaintiffs has stated in discussing the opinion of the court below that: "Despite the Court's reservation, it is difficult to perceive how the relationships and allegiances between the inside and outside directors of a mutual fund that were adverted to by the Court would be different in the case of any other kind of corporation." Bernstein, *Securities-Class Actions*, N.Y. Law Journal, March 22, 1978, at 24, n. 6.

tion, there is no logical distinction between the facts presented here and situations where a board majority (*e.g.*, 60%) is independent. As long as any board member was allegedly involved in the acts complained of, those who were not involved would be under the same presumptive disability to pass fairly on the wisdom of the claims. Rule 23.1 and the policies which it embodies have thus been emasculated, since there is little purpose in requiring a demand on independent directors who are disqualified as a matter of law from exercising their business judgment concerning the corporation's best interests.

The language which the court below used to set forth its presumption can be expected to appear repeatedly, with minor variations, in those portions of innumerable future derivative complaints involving all kinds of public corporations, not merely mutual funds, explaining why demand on the board of directors should be excused. In this sense the court's presumption will serve only to exacerbate the existing conflict in the circuits over the proper interpretation of the demand requirement of Rule 23.1.[26]

[26] Shareholder derivative suit plaintiffs have already begun citing the opinion of the court below as a basis for opposing dismissal motions based on Rule 23.1. In *Untermeyer, supra*, such a claim was rejected on the strength of *Kauffman* and *Heit, supra*. The district judge noted that, because the opinion below "does not address the requirement of demand on the board of directors, and comments that Rule 23.1 cases are inapposite," *id.*, at 93,513, n. 17, it is not strictly inconsistent with those earlier decisions of the First Circuit. The court, however, went on to expressly reject the presumption employed below: "To the extent that *Lasker* assumes the independent directors to be captive to the will of the interested directors, this court disagrees." *Id.* We question the *Untermeyer* court's attempt to distinguish the opinion below. In our view, application of the presumption to facts such as those in *Kauffman* and *Heit, supra*, where complaints were held deficient because they did not show that majorities of the boards were disabled from exercising their business judgment, would call for different results in those cases.

The Court of Appeals obviously was not entirely comfortable with this result, because it sought to ameliorate the harshness of its new rule by suggesting that it should only apply to "non-frivolous" actions. *Id.* Although it did not specifically define a "non-frivolous" action, the court was apparently referring to that class of case where the court "cannot say that, following a trial on the merits, the defendants would be found free from liability," *id.*, at 1210; in other words, for example, cases where a motion to dismiss for failure to state a claim would be denied.

However, this test only increases the potential for excessive derivative litigation created by the decision below, because it necessarily excludes numerous other business considerations (unrelated to the legal merits of the proposed case) which this and other courts have frequently recognized as appropriate to a prudent decision as to whether or not a corporate claim should be pursued.[27] As this Court stated in *Corbus* v. *Alaska Treadwell Gold Mining Co., supra:*

> "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right." 187 U.S., at 463.[28]

[27] This result conflicts with the Second Circuit's own prior precedent in *Fogel* v. *Chestnutt, supra,* where a different panel of the court stated that the performance of statutory duties by mutual fund independent directors required them to evaluate both "legal difficulties" and "economic pros and cons," 533 F.2d, at 749-50. The importance of non-legal considerations is supported by extensive precedent permitting the weighing of non-legal factors in the decision whether or not to pursue corporate claims. *See, e.g., Bernstein* v. *Mediobanca,* 69 F.R.D. 592, 597 (S.D.N.Y. 1974); *Puma* v. *Marriott, supra; Findley* v. *Garrett,* 109 Cal.App.2d 166, 240 P.2d 421, 426 (1952); *Goodwin* v. *Castleton,* 19 Wash.2d 748, 764, 144 P.2d 725, 733 (1944).

This Court is well aware of the fact that shareholder derivative litigation—although sometimes necessary to vindicate corporate rights—is often abused. The court below, in erecting a "frivolous case" exception as the only escape from its new presumption, has added a powerful new weapon to the arsenal of shareholder's counsel, particularly so if, as we submit, the presumption cannot logically be confined to the mutual fund context. As long as derivative complaints can be drafted so as to avoid motions to dismiss, all such cases will seemingly require a full trial on the merits despite the fact that there is often an independent quorum of directors ready to assess fairly, and with unassailably competent and independent advice from counsel, the proposed case and its effect on the corporation. As this Court recently observed in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 742 (1975), once commenced, shareholder derivative litigation is "virtually impossible to dispose of prior to trial other than by settlement."

[28] Protracted stockholder derivative litigation inevitably has a major impact upon a corporation's affairs, and consideration of many factors beyond mere courtroom "non-frivolousness" is thus central to sound exercise of directorial responsibilities and, ultimately, to corporate well-being. Recent litigation in the federal securities law area has amply demonstrated that cases with initially bright prospects may ultimately result in irretrievable dissipation of corporate energies and resources, *compare Mills* v. *The Electric Auto-Lite Co.,* 396 U.S. 375 (1970), *with* 552 F.2d 1239 (7th Cir. 1977). This Court recognized in *Blue Chip Stamps, supra,* at 740, that "[t]he very pendency of [shareholder] lawsuit[s] may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit."

Such a result is unnecessary, and indeed unwise. The District Court's approach in this case, as we urge above, has a far stronger basis in law, policy and logic, for it preserves the right of truly independent directors generally, and independent directors of mutual funds in particular, to resolve internally the question whether a claim should be pursued, while permitting judicial evaluation of the limited issue of the directors' independence. "If a stockholder could compel the officers [of a corporation] to enforce every legal right, courts, instead of the chosen officers, would be the arbiters of the corporation's fate." *Ashwander* v. *Tennessee Valley Authority,* 297 U.S. 288, 343 (1936) (Brandeis, J., concurring). By strengthening the hand of derivative plaintiffs in mutual fund litigation (and, by logical extension, in corporate litigation generally), the court below necessarily has expressed a preference for judicial resolution of such intra-corporate disputes. That result—and the concomitant increase in complex federal court litigation—should be based on firmer footing than the vague presumption relied upon below.

In the concluding section of this brief we show that there is nothing in the framework of statutory and decisional law applicable to mutual funds which supports the creation of such a presumption, even if its effects could somehow be limited to the mutual fund context. Indeed, we demonstrate that the court drew precisely the *opposite* conclusion from that intended by the Investment Company Act, with the result that the opinion below places independent directors of mutual funds under a special disability in attempting to exercise the "watchdog" function expressly intended for them by Congress and confirmed by previous decisions in both the First and Second Circuits.

III. The Opinion Below Creates a Conflict Among the Circuits as to the Duties of Mutual Fund Independent Directors Under the Investment Company Act

The decision below conflicts with prior interpretations of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.,* in both the First and Second Circuits. The interpretation which the court below gave to the Investment Company Act is of critical importance to its decision because the framework of the Act was said to provide one basis for departing from what the court acknowledged was a "plethora" of cases upholding "the powers of boards of directors to terminate stockholder derivative suits." 567 F.2d, at 1212, n. 14.[29]

On more than one occasion the Supreme Court has stated that the *only* circumstance under which it would be willing to uphold interference with the state law of corporate governance is "where federal law expressly requires [it]," *Cort* v. *Ash, supra,* 422 U.S., at 84; *Santa*

[29] Nine such decisions, including four by this Court, were cited by the District Court, 404 F.Supp., at 1179. The court below also offered as a basis for its decision what it described as "the unique nature of the investment company and its symbiotic relationship with its investment adviser," 567 F.2d, at 1212, n. 14. The link between this observation and the presumption which the court employed was never explained. Although we believe that application of the presumption cannot logically be confined to corporations which happen to be mutual funds, see Point II, *supra,* our position is that, assuming *arguendo* such a limitation exists, the court below erred in the conclusion it drew based on the Investment Company Act of 1940. Moreover, the court failed to examine what significance, if any, such a factor might have under controlling state law. *See,* Point I, *supra.* The District Court had found the controlling law on this question to be that "absent a showing of improper motive they [the independent directors] have always been permitted to apply their business judgment to decisions involving derivative suits against [affiliated] corporations they serve," citing *Warshaw* v. *Calhoun,* 43 Del.Ch. 148, 221 A.2d 487 (1966). *See,* 426 F.Supp., at 849.

Fe Industries, Inc. v. *Green, supra,* 430 U.S., at 479. This Court has never found such a situation to have occurred, and there is clearly no provision of the Investment Company Act, express or otherwise, which satisfies that test. Indeed, the Court of Appeals did precisely what *Santa Fe* directs the federal courts not to do. By sweeping aside "established state policies of corporate regulation" the decision herein would "federalize" a "substantial portion of the law of corporations" in the complete absence of anything even resembling a "clear indication of congressional intent." 430 U.S., at 479.

The statutory provisions relied upon by the court below were those sections of the Investment Company Act which require 40% of the membership of mutual fund boards of directors to be unaffiliated with the fund's investment adviser, 15 U.S.C. §§ 80a-2(a)(3) and (19), 80a-10(a), and which provide for shareholder suits challenging the level of compensation provided for in the investment advisory contract, but seeking no other relief. 15 U.S.C. § 80a-35(b).

But the legislative history of the 1970 amendments to these very sections reveals Congress' intention to strengthen the standards for independence of mutual fund directors not affiliated with the investment adviser through the use of a newly defined term, "interested person." Indeed, the Senate Report accompanying the 1970 amendments reveals that even with respect to the specific issue addressed by the amendments—the level of investment advisory fees set by an adviser's contract with a fund—the new statutory language "is not intended to authorize a court to substitute its business judgment for that of the

mutual fund's board of directors," S.Rep. No. 91-184, 91st Cong., 1st Sess. at 33 (1969), *reprinted in* [1970] U.S. Code Cong. & Admin. News 4897, 4902. Since the legislation relied upon by the court below was plainly intended not to supplant the business judgment rule even in the area of advisory fees, *a fortiori* it can supply no basis for disenfranchising directors from control in other areas. Indeed, with respect to mutual fund governance generally the Senate Report states that:

> "The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, at 34.

Thus, far from supplying the necessary "clear indication of congressional intent" required by *Santa Fe* in order to supplant state law, if anything the statutory sections relied upon by the Court of Appeals as the basis for its decision reveal a clear intent to the contrary.[30]

Even more remarkable is that another Circuit had previously found the same sections of the Investment Company Act to express Congress' intent to strengthen and enhance the exercise of independent directoral judgment, rather than to withdraw it. In *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), a decision not even cited by the court below, a mutual fund shareholder suing derivati-

[30] Interpretation of the federal securities laws in a manner opposite from or contrary to the intent of Congress, even by specialized agencies such as the Securities and Exchange Commission, is not unknown. *Cf., SEC* v. *Sloan,* ___ U.S. ___, 46 LW 4426, 4428-29 (May 15, 1978).

vely for his fund's benefit sought damages from the fund's investment adviser under the Investment Company and Clayton Acts for allegedly excessive advisory fees. There, as here, the shareholder claimed that the independent directors whose presence on the mutual fund board was mandated by the Investment Company Act were disqualified from exercising their business judgment as to the disposition of the proposed claims against the investment adviser because the adviser "dominated and controlled" the entire fund board. 479 F.2d, at 262. The shareholder's claim that demand on the directors was excused because different rules of directorial control of corporate affairs should be applied in light of the peculiarities of the mutual fund business and Congress' passage of the Investment Company Act was emphatically rejected by the Court of Appeals for the First Circuit:

> "Nor do we think that an exception [to the business judgment rule] is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. . . . We do not believe . . . that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from disinterested directors in any other corporate venture. . . . To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." 479 F.2d, at 266-67.

Quite obviously the *Kauffman* court and the court below cannot both be right. Interpreting the same statute, the First Circuit clearly stated that Congress did not intend to repeal well-established limitations upon the availability of stockholder derivative actions, and that an independent mutual fund director (just as any other corporate director) should properly decide whether pursuit of claims against the fund investment adviser is in the fund's best interests. The Second Circuit has reached the opposite conclusion in the case at bar.

Moreover, the position of the court below conflicts with prior decisions of the Second Circuit. In *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976), the Second Circuit had determined that independent mutual fund directors should as a matter of Investment Company Act policy not be deprived of the opportunity to exercise their business judgment with respect to fund claims against the investment adviser, and that the independent directors were entitled to full disclosure of potential fund-adviser conflicts for the very purpose of "exercis[ing] the independent judgment that Congress clearly intended." 533 F.2d, at 745. *Fogel* made clear that if, after full disclosure, independent fund directors determined not to pursue fund claims against the investment adviser, such decision would be upheld as "a reasonable business judgment." *Id.,* at 750. The decision

below also conflicts with *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir. 1977), *cert. denied,* 98 S.Ct. 421 (1977), where the Second Circuit held, largely in accordance with the *amicus curiae* argument of the Securities and Exchange Commission, that a mutual fund breach of fiduciary duty claim raised derivatively by a shareholder against the investment adviser was fully subject to independent directorial control under the business judgment rule. *Id.,* at 418-19. With respect to Congressional intent, the Second Circuit held in *Tannenbaum* that:

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the [fiduciary monies sought to be recovered by the shareholder-plaintiff] from the informed discretion of the independent members of a mutual fund's board of directors." *Id.,* at 417.

Thus, at the very least the decision below has resulted in an unsettled state of the law that is both confusing to the mutual fund industry and disruptive to the management of an important segment of our financial economy. If the Court of Appeals' decision is not promptly revised in harmony with the business judgment rule, the inevitable consequence, even if that decision is confined to the mutual fund context, will be to shift major matters of mutual fund management from the board room to the federal courtroom—a result surely not required by the Investment Company Act. A single disgruntled shareholder who can produce a complaint attacking some of the directors which can withstand a motion to dismiss can totally preempt the corporation's independent directors on

the matter at issue, and have the decision which he or she wishes to challenge reviewed by a federal court. The system of mutual fund management contemplated by Congress and previously implemented by the courts will become as anarchistic as the business judgment rule is democratic.

Conclusion

For the foregoing reasons, it is respectfully urged that the petition for a writ of certiorari should be granted.

June 9, 1978

Respectfully submitted,
JOHN E. TOBIN
ROGER W. KAPP
RICHARD H. SAYLER
BRENT L. BRANDENBURG
Attorneys for Investors Diversified Services, Inc.
30 Rockefeller Plaza
New York, New York 10020

DONOVAN LEISURE
NEWTON & IRVINE

JOSEPH F. GRINNELL
Senior Vice President-Law
Investors Diversified Services, Inc.
Of Counsel

APPENDIX

APPENDIX A
Rules and Statutes Involved

Delaware General Corporation Law

§ 141. Board of directors; powers; etc.

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of 1 or more members. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors. Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater

number. Unless the certificate of incorporation provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than ⅓ of the total number of directors except that when a board of 1 director is authorized under the provisions of this section, then 1 director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.

* * *

Investment Company Act of 1940

§ 36. Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules,

regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Aug. 22, 1940, c. 686, Title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.

Rule 23.1, Federal Rules of Civil Procedure

Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the

action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Added Feb. 28, 1966, eff. July 1, 1966.